

Assessment of industry risk is an essential part of credit rating process. The industry risk assessment sets the ceiling for ratings of individual entities within a given industry. It focuses on the degree of cyclicity and the strength of competitive forces along with the extent of capital intensity, vulnerability to technological change, level of regulatory interference and energy sensitivity. All these factors are assessed on a scale ranging from High to Low to assign an overall risk level to each industry. Industry risk categorization for different industries is available on our website under Sector Updates “Industry Risk Analysis” (<https://docs.vis.com.pk/docs/Industryrisk062021.pdf>).

This document explains VIS approach to assess industry risk of Leather industry of Pakistan.

The Leather sector of Pakistan is predominantly export oriented industry, contributing around 3-4% share in the total exports of the country. The industry is classified into five sub-sectors according to the type of product being produced. These sub-sectors include tanning (finished leather), leather apparel and clothing, leather gloves, leather footwear and other leather manufacturers. The industry is regulated by Ministry of Industries, while trade bodies like Pakistan Tanners’ Association, Pakistan Leather Garments Manufacturers & Exporters Association and Pakistan Footwear Manufacturing Association represent the industry and act as a bridge between government and the industry.

Demand for leather is mainly associated with urban population growth and rising household income. During the past five years, the aggregate leather exports have depicted a declining trend albeit posting moderate recovery during FY21, mainly in the value added segment. The reason for declining trend has been the overall contraction in global leather demand further aggravated by the onset of COVID-19, increasing shift towards artificial leather as well as challenges faced by the domestic industry in terms of product diversification, technological up gradation and compliance with environmental regulations. Going forward, while the industry remains exposed to global freight challenges, we expect the industry to record modest growth led by the value added segment on account of gradual shift of demand to Pakistan from other regions.

### OVERALL INDUSTRY RISK

High
High to Medium
<b>Medium</b>
Medium to Low
Low

Figure 1: Leather Sector Export In Pakistan (In USD Million)

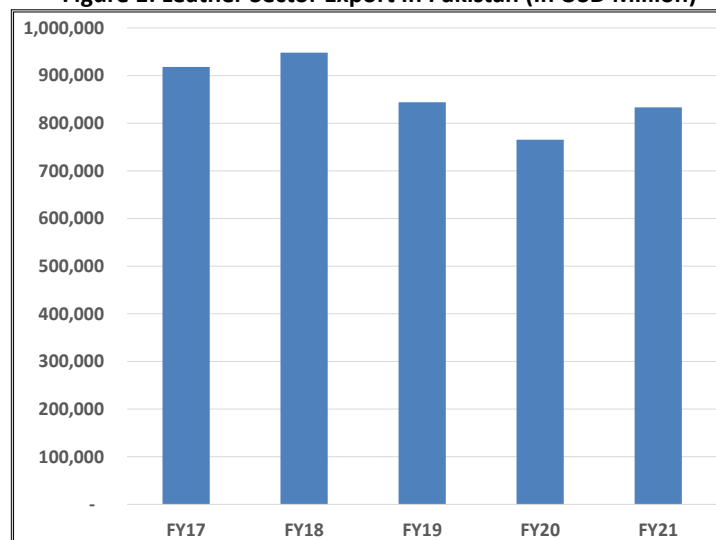


Table 1: Leather Exports Breakup (In USD Million)

	FY19	FY20	FY21
Tanned leather	252.2	184.2	161.9
Leather garments	256.3	250.9	286.1
Leather gloves	217.9	212.8	260.1
Leather footwear	106.4	107.2	108.4
Others	11.4	10.3	16.5
<b>Total</b>	<b>844.3</b>	<b>765.3</b>	<b>833.2</b>

Source: Pakistan Bureau of Statistics

The major raw material used in leather industry is animal hides. Availability of livestock population is abundant in Pakistan but lacks in efficient management and collection of animal hides creating hurdles for the smooth operation of the industry. The overall collection of hides has depicted a 20% drop from 2020 during Eid-ul-Azha (major source of hides' collection) owing to the COVID-19 pandemic, low purchasing power of the people and less spending by consumers and overall business environment. This has resulted in rise in the prices of the animal hides purchased by leather manufacturers which is expected to impact margins in the ongoing year, although currency devaluation is likely to offset the increase in costs.

Leather is mainly used in fashion accessories, mostly supplementary to other clothing items and while demand for premium fashion products continue to rise, demand dynamics remain exposed to volatility in economic activity, including income levels. As such, leather industry has been assessed as High risk on account of cyclical nature. A quantitative analysis was also conducted using VIS industry database earnings depicted a close correlation to changes in economic downturns.

Assessment of competitive risk captures barriers to entry, availability of substitutes and risk in growth trends. Barriers to entry in the leather sector are considered low given the significant number of small to medium sized players. More than 800 players exist in the industry majorly small scale players; indicative of a lower investment size with no significant technical or branding cost involved. However, presence of large number of players in an industry that has been registering a decline for the last couple of years together with more stringent environmental regulations to comply with provides a deterrent against new players to some extent and therefore the risk of effectiveness of barriers to entry is considered medium.

The risk of substitution in the leather industry remains Medium. The market trend for synthetic leather is gaining momentum. Increasing market demand for synthetic leather is reinforced by growing awareness about animal rights and also comparatively lower prices of faux leather available in the market. However, leather is still predominantly used in the major markets across the world. Therefore, risk of substitution in the leather sector is considered Medium.

Risk in Growth trends in this sector remain high; driven by environmental issues as the leather manufacturing process causes great harm to the environment (due to which the leather industry has shifted from industrialized world to the developing countries) and availability of many synthetic leather alternatives offering comparatively lower prices. Therefore, given Low barriers to entry, Medium risk of substitution and High risk in growth trends, overall competitive risk for the sector is assessed as High to Medium.

On the capital expenditure front, capital intensity has been assigned as Low risk. Capital intensity parameter measures the risk of entering the industry assessed by the level of capital requirement, tenure of return on capital, and access to debt/equity financing. While research and development expenditure is required for producing innovative leather articles and investment in training of labor to acquire enhanced skills, level of investment expenditure for establishing a tanning facility is considered low when compared with other capital intensive industries.

Technology risk is considered Medium as Pakistan's Leather industry is characterized with not much substantial R&D spends. There is not a significant requirement of technological implementation however; the shortage of skilled labor along with inadequate vocational training does impact the prospects of the leather industry. Vocational training institutes do not produce a sufficient number of highly skilled workers for the leather industry and the manufacturing unit remains dependent on the unskilled and semi-skilled workforce. Risk is considered medium given changing preferences. To remain competitive in the export markets, companies will have to invest in environmentally friendly technology and processes and therefore assessed as medium risk for technological risk. Regulatory Risk for the leather industry is considered Medium to Low. While prices of final leather products are based on market forces of demand and supply in line with the competitive forces in the international markets, with little or no intervention by

the Government, being an export oriented industry, manufacturers do enjoy some incentives in the form of duty drawback and export rebate. In addition, given the enhanced focus on environmental issues the sector may attract some regulatory intervention or action in the long term to ensure sustainability of leather exports.

Energy sensitivity as a risk parameter for evaluating industry risk encapsulates the availability and cost of energy as a proportion of their total production costs. Energy requirements for running plants are considered to be on the lower side when compared to other industries and constitute a minor proportion in total costs, accounting for approximately 8-11% of manufacturing cost. Raw material (i.e. animal hides) cost comprise major portion. However, the skin, being perishable, cannot be stored without first being processed, which requires uninterrupted supply of electricity and gas. Therefore, energy sensitivity has been assigned Medium to Low Risk .On the basis of all the risk factors discussed above, the **overall Industry Risk** of the leather industry has been assigned as **Medium**.

**Table 2: Summary of Industry Risk Factors**

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Cyclicalit	Competition				Capital Intensity	Technology Risk	Regulatory Framework	Energy Sensitivity	OVERALL RISK
	Risk of Effectiveness of barrier to entry	Risk of Substitutes	Risk in Growth Trends	Overall					
High	Medium	Medium	High	High to Medium	Low	Medium	Medium to Low	Medium to Low	<b>Medium</b>

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